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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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FEDERAL COMMUNICATIONS COMMISSION
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In the Matter of	)	
	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
	)	
Treatment of Operator Services Under Price Cap Regulation	)	CC Docket No. 93-124
	)	
Revisions to Price Cap Rules for AT&T	)	CC Docket No. 93-197

MOTION FOR ACCEPTANCE OF LATE-FILED PLEADING

The National Cable Television Association ("NCTA"), by its attorneys, respectfully requests that the Commission accept for filing the attached "Reply Comments of the National Cable Television Association" in the above-captioned proceeding.

NCTA's Reply Comments were ready for filing on the original January 16, 1996 due date. The deadline was subsequently extended to February 6, 1996. Recent events relating to the passage of the telecommunications legislation resulted in NCTA's failure to file yesterday. No parties to this proceeding should be prejudiced by the grant of this motion because these comments are the last in the pleading cycle for this proceeding.

We regret any inconvenience caused by our error, and request that these comments, including the accompanying "Reply Declaration of Dr. Leland L. Johnson, be accepted for inclusion in the record of this proceeding.

Respectfully submitted,

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Counsel for the National Cable Television Association, Inc.

February 7, 1995

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REPLY COMMENTS OF
THE NATIONAL CABLE TELEVISION ASSOCIATION

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REPLY COMMENTS OF THE NATIONAL CABLE TELEVISION ASSOCIATION

The National Cable Television Association ("NCTA"), by its attorneys, hereby replies to the comments submitted in response to the Commission's Second Further Notice of Proposed Rulemaking in Price Cap Performance Review for Local Exchange Carriers ("Second Further Notice").

INTRODUCTION AND SUMMARY

The Second Further Notice proposes modifications to LEC pricing procedures irrespective of the level of competition, and invites interested parties to address the competitive circumstances that could trigger even more reduced regulatory oversight of local telephone companies. Specifically, the Commission requests comment on whether local telephone companies should obtain some forms of pricing flexibility even though competitive conditions are neither demonstrated nor present. Parties are asked also to offer views on the conditions that might warrant the conclusion that the essential preconditions to competition are satisfied (i.e., a competitive checklist), and the circumstances that justify "streamlined" regulation and "nondominant" status.

NCTA, in response, maintained that the pervasive dominance of local telephone service monopolies throughout the United States prevents the granting of any further regulatory relief. This condition is not changed by "price cap" regulatory schemes, which the telcos advance as a sort of "magic wand" that transforms their transmission monopolies into competitive businesses. Those who take their comments seriously must be genuinely surprised to discover that the local telephone monopoly remains near absolute.

In our initial comments, we showed through the Declaration of Dr. Leland L. Johnson that price caps in practice (as opposed to "pure" price caps, which exist only in theory) fail to "break the link" between prices and costs, and that regulators will continue to review costs to support rates. Anticipating this review process, telephone companies will retain the incentive and ability to shift costs improperly to monopoly services, thereby justifying higher rates for these services and lower rates for the competitive services. Although predatory pricing is not expected by firms operating in a competitive market, the regulated firm will be inclined to predatorily price more competitive services if the revenue shortfalls anticipated by the predatory behavior can be recovered from the regulated monopoly services. The chances for successful predation will be particularly great if the monopoly and competitive services share common facilities, thereby limiting the ability of regulators to detect improper cost shifting.

The LECs deny the possibility of cross-subsidy and argue for adoption of the Commission's proposal calling for significant pricing flexibility irrespective of whether, and the extent to which, competition is present or likely to develop. Even with respect to streamlining and nondominant status, several LEC parties concoct ludicrous rationales for deregulation that do not rely upon the presence of actual competition.

Faced with the fact that local telephone companies provide no demonstrable evidence of actual competition, the only reasonable conclusion is that the local telephone monopoly is intact. There is no basis for providing LECs with additional pricing flexibility beyond the volume and term discounts and zone density pricing arrangements previously approved. The comments of the many parties hoping to gain a competitive foothold in the LECs' monopoly markets demonstrate that additional relief should be contingent upon the development of effective facilities-based competition. This is especially true because of the compelling evidence that LECs are affirmatively acting to block competitors from offering services to consumers at reasonable rates.

I. IF THE COMMISSION ADOPTS THE LECS' VERSION OF PRICE CAPS, MASSIVE CROSS-SUBSIDIZATION AND PREDATORY PRICING WILL RESULT

The LECs strain mightily, and unpersuasively, to support findings that overstate the state of competition, and to support conclusions that are economically and logically unsustainable. The Commission should reject the LECs' proposals. Telephone companies should be accorded no additional pricing flexibility until they are subject to effective and demonstrable facilities-based competition. Further consideration of streamlining and nondominant status should be formally deferred.

The LECs' case for reductions in regulatory scrutiny, considered collectively, rests primarily upon three interrelated points. They argue: (1) price caps prevent local telephone companies from raising rates to fund the subsidies necessary to support predatory pricing; (2) predatory pricing is not a real concern in telecommunications because the marginal costs of operation are very low relative to the fixed costs of network construction, and, because of the low operational costs relative to fixed costs, the incumbent would face extreme difficulty were it to attempt to employ a predatory pricing strategy to drive a competitor from the market; and (3) since the threat of anticompetitive cross-subsidization is not a real threat, the competitive services of monopoly carriers should be fully deregulated. As more fully explained in the Reply Declaration of Dr. Leland L. Johnson, appended to NCTA's Reply Comments, each of these propositions, and collectively the LECs' economic case for pricing flexibility and even more drastic regulatory changes, is demonstrably incorrect.

A. Price Caps As Proposed By the LECs Do Not Constitute An Effective Safeguard Against Cross-Subsidization

Price cap schemes represent an improvement over rate of return regulation, but they are not a regulatory panacea. Their mere adoption in any of the forms proposed does not eliminate the LECs' incentives to predatorily price services that face competition, or to cross-subsidize these service offerings. For a price cap scheme to achieve that objective, the plan must permanently sever the relationship between prices and costs. As we noted in our initial Comments, Professor Kahn in previous testimony in another proceeding, and Dr. Johnson on behalf of NCTA in this proceeding, are in agreement on this point.

In a statement submitted in this proceeding, Professor Kahn on behalf of Bell Atlantic, reiterates that the adoption of "pure" price caps by the Commission would effectively eliminate the possibility that the LECs would be able to increase rates to finance predatory pricing and cross-subsidization. According to Professor Kahn, the "obvious solution to the problem of cross-subsidization, therefore, is ... to abandon any remaining elements of rate base/rate of return [regulation.]"[1] Rate base/rate of return regulation should be replaced with pure price caps, because under pure price caps the link between prices and costs is broken. Professor Kahn concludes that "[i]n its pure form direct price regulation eliminates any entitlement of regulated

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1 Affidavit of Alfred E. Kahn, appended to Comments of Bell Atlantic, CC Docket No. 94-1, Dec. 11, 1995, at 12-13 ("Kahn Affidavit").

companies to recover from monopoly customers any reductions in rate of return resulting from price cuts in regulated markets."[2]

Assuming that Professor Kahn's conclusion is correct, the key issues are "How is 'pure' price caps defined?" and "As defined, do 'pure' price caps protect against anticompetitive cross-subsidization?" Professor Kahn appears to maintain in his Bell Atlantic affidavit that a price cap plan is "pure" if sharing is eliminated and there is no "lower end adjustment." But a scheme with these characteristics would not "solve" the problem of potential cross-subsidy. Such schemes "are nevertheless subject to periodic review whereupon past performance is evaluated (including the historic rate of return) and adjustments made in the productivity factor and other elements of the formula to bring the projected rate of return in line with what regulators would regard as acceptable."[3] This is exactly what happened with AT&T--the case that Professor Kahn uses as an example of pure price caps--when the Commission conducted its three-year review of the AT&T price cap plan. Rather than operating under pure price caps, AT&T (prior to the recent classification of AT&T as a nondominant carrier) operated under what amounted to rate of return regulation with a time lag.[4]

Dr. Johnson illustrates the problem with an example. A hypothetical LEC that does not offer a competitive service charges prices that reflect inflation less a productivity factor of four percent. Subsequent annual regulatory reviews maintain the productivity factor at four percent, which means rates are forced down each year by four percent less inflation. The situation is more complicated, however, if the LEC also offers a competitive service. In that circumstance, the LEC has the incentive to improperly attribute some of the costs associated with the competitive service to the monopoly service. If regulators fail to challenge the costs associated with each service in subsequent reviews, the LEC can claim a productivity factor lower than four

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[2] Id. at 13.

[3] Reply Declaration of Dr. Leland L. Johnson, appended to Reply Comments of the National Cable Television Association, Jan. 16, 1996, at 10 ("Johnson Reply Declaration").

[4] Id. at 11.

percent is justified for the monopoly service. The lower productivity factor translates to higher monopoly service rates. The difference between the rates calculated based on the productivity factors generated through properly and improperly attributed costs is the amount of the cross-subsidy.[5]

The price cap schemes described in the statements of Professor Kahn on behalf of Bell Atlantic, and Professor Hausman for BellSouth, are "real world" plans in which the link between prices and costs is not broken. Rather, these real world price cap schemes contemplate continuing review of a LEC's costs as part of the regulatory review of rates. In contrast, true "pure" price caps "break the link" between prices and costs, and there is a very practical explanation why these schemes do not exist: If a LEC's prices are persistently high, regulators will be forced to make a downward adjustment. Low profit levels or losses will result in pressure for an upward adjustment.

Professor Kahn, in earlier testimony before the Canadian Radio-Television and Telecommunications Commission, rejected the possibility of pure price caps in the real world. In that testimony, he noted that all existing price cap schemes contemplate periodic rate reviews, and defined a pure price cap as one in which rates are not reviewed periodically:

> Since the indexation formulas are inevitably based on estimates--in particular estimates of how the costs of the regulated companies may be expected to behave relative to the basis for indexation (such as the Consumer or GNP price index)--it is difficult to imagine a scheme under which the government would surrender for all time the option of testing the accuracy of those estimates against actual experience. Such reexaminations have typically involved some correction of the formula if profits prove too high or too low--in which event price regulation turns out to resemble rate of return regulation.[6]

It follows that the implementation of price caps as proposed by the LECs will not eliminate the requirement that regulators continue to police the LECs' costs.

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5 See Johnson Reply Declaration at 11.

6 Kahn, Review of Regulatory Framework, Canadian Radio-Television and Telecommunications Commission, Telecom Public Notice CRTC 92-78, filed on behalf of AGT, Apr. 13, 1993, at 21 (emphasis in original).

B. LECs Regulated Under Price Caps Retain Incentives to Predatorily Price Competitive Services

Professor Hausman maintains that predatory pricing is "not a realistic concern" in telecommunications because marginal costs associated with network operation are very low compared with the fixed costs of network construction.[7] In these circumstances, a LEC would face extreme difficulty in pursuing a predatory pricing strategy intended to drive competitors from the market, because once the network is constructed and the network costs are sunk, the marginal cost for the competitor to remain in the market is extremely low. The competitor would remain in business so long as it is able to cover its very low marginal costs, while the incumbent would have to expend "enormous sums" to price sufficiently low to damage the new entrant. Professor Hausman further contends that even if the incumbent successfully drove the new entrant out, it would have little assurance that new entry would not occur once the incumbent raised prices to recover the losses sustained by its predatory activities.

Professor Hausman's analysis is flawed in three critical respects. First, as a factual matter, the marginal costs of network operation are not "very low" in relation to fixed costs; to the contrary, they are very high. According to FCC Statistics of Communications Common Carriers 1992/93, for both AT&T and the LECs, Total Operating Expenses, which can be taken as an approximation of the marginal cost of operating the fixed network, significantly exceed the "fixed cost" categories, including Depreciation and Amortization, Interest and Related Items, and Net Income. For AT&T, Total Operating Expenses were 86 percent of the total.[8] Total Operating Expenses for all reporting LECs were 60 percent of the total.[9] The clear implication

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[7] Statement of Professor Jerry A. Hausman at 8-11, appended to Comments of BellSouth Telecommunications, Inc., CC Docket No. 94-1, Dec. 11, 1995.

[8] Johnson Reply Declaration at 5, citing FCC Statistics of Communications Common Carriers: 1992/93, at 41-42.

[9] Id., citing FCC Statistics of Communications Common Carriers: 1992/93, at 43.

is that "the recurring costs of maintaining a viable business enterprise far surpass the sunk costs in the physical network itself."[10]

Professor Hausman's analysis is flawed for the additional reason that he does not acknowledge that predation may be employed as an anticompetitive strategy before costs are sunk. A new entrant might be discouraged from commencing construction of its network if it were faced with an incumbent LEC's threat to engage in predation. For similar reasons, the prospect of predation by the incumbent might persuade the new entrant not to complete construction of a partially built network, or to defer plans for expansion. In these circumstances, the LEC will be able to successfully discourage the development of competition that might otherwise arise.

Finally, Professor Hausman misses the key point that even though predatory pricing may be an unlikely competitive strategy in markets that are not regulated, incentives are not the same in regulated markets. Dr. Johnson explains:

> Presumably, in the absence of regulation, the firm would seek to set prices in its monopoly market to maximize profits, with any higher (or lower) prices resulting in a reduction in profit. If, in this circumstance, the firm finds an opportunity to enter a competitive market, any payments for subsidies to that market would represent an up-front financial loss. In other words, the firm would be unable to raise prices to its monopoly ratepayers as a way to obtain additional revenues for subsidies elsewhere, for it would already have fully exploited whatever monopoly power it has.[11]

The situation with the regulated firm is very different. Regulation of the monopoly service prevents the regulated firm from fully exploiting its monopoly power. But if the regulated firm is able to shift costs from the competitive to the regulated service, "the up-front costs of predatory pricing would come at the expense of ratepayers rather than of stockholders."[12] Rate-of-return regulation has been criticized precisely because its 'cost plus' approach facilitates

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[10] Johnson Reply Declaration at 7.

[11] Id. at 7-8 (emphasis in original).

[12] Id. at 8.

anticompetitive cost-shifting.[13] Without proper regulatory supervision, price cap schemes result in the same problem.

C. So Long As LECs Retain A Monopoly Over Basic Telephone Service, The Transmission Services Delivered Over The Integrated Network Should Remain Subject To Regulation

Finally, Professors Gilbert and Harris, on behalf of Bell Atlantic, contend that LECs should be allowed to introduce "new services or implement price changes for existing price capped services with one-day notice and no cost support provided existing services remain available to customers."[14] In a similar vein, Professor Kahn argues that particular LEC services should be deregulated as they face competition, so that regulatory asymmetries and distortions to competition are eliminated.[15] He cites Bell Atlantic's video dialtone service, which will face competition from the incumbent cable operators, as an example of a service that ought to be removed from price cap regulation.[16]

But these assessments hold only if the threat of anticompetitive cross-subsidization is ignored. Professors Gilbert and Harris urge that so long as a competitive service covers its incremental cost, anticompetitive pricing is not a problem. In these circumstances, they argue, LECs should be permitted to offer alternative pricing plans, including volume and term discounts. But this analysis is incomplete.

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13 H. Averch and L. Johnson, Behavior of the Firm Under Regulatory Constraint, American Economic Review, Dec. 1962.

14 Affidavit of Richard J. Gilbert and Robert G. Harris at 3, appended to Comments of Bell Atlantic, Dec. 11, 1995.

15 Kahn Affidavit at 13.

16 Id. at 14.

Even if regulators require an incremental cost-based price floor, if LECs are permitted to file tariffs on one-day notice with no cost support, there will be no means of determining whether, or assuring that, prices for competitive services cover at least their incremental cost. It is for this reason that Dr. Johnson concludes that " the Commission--as well as state regulators--must continue to oversee the assignment of costs between monopoly and competitive services until the monopoly service has evolved into a competitive one unable to support subsidies to other services."[17] Or, to use the formulation of Professors Gilbert and Harris, the only way of enforcing "... a price floor based on incremental cost to protect against anticompetitive pricing"[18] is to maintain regulatory supervision of the rates and costs associated with the LECs' monopoly and competitive services until the monopoly service faces effective competition.

II. THE LECS' DOMINION OVER LOCAL TELEPHONE SERVICE PRECLUDES ADDITIONAL PRICING FLEXIBILITY AND OTHER RELIEF

It is abundantly clear from the comments submitted in response to the Second Further Notice that the LECs have been given a fair opportunity to justify further regulatory relief, and they have failed miserably. Only by accepting their misguided economic analyses, and by fundamentally misreading the realities of the telecommunications marketplace, could the Commission give serious consideration to the LECs' proposals. The Commission must put aside the LECs' proposals to a later time when competitors are offering consumers genuine choices among service providers, and the LECs' incentive to cross-subsidize more competitive service offerings is no longer so great.

NCTA's comments explained that to grant LECs additional pricing flexibility in an environment where there is only a single provider is not a "neutral act." Rather, it would enable

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[17] Johnson Reply Declaration at 16.

[18] Richard J. Gilbert and Robert G. Harris at 3, appended to Comments of Bell Atlantic, CC Docket No. 94-1, Dec. 11, 1995.

LECs to lower prices in anticipation of efficient competition, and thereby deter actual competition. With Congress considering comprehensive telecommunications legislation, this is the wrong time to grant LECs additional pricing flexibility.[19]

It is far better policy, and it makes a lot more sense, for the Commission to condition additional pricing flexibility upon the presence of effective competition, and the LECs' compliance with a competitive checklist provided for in the pending legislation. That way LECs will have powerful incentives to accommodate competitors in appropriate ways. Moreover, pricing flexibility for LECs should be considered only as part of comprehensive action to open telecommunications markets to competition, and to establish new procedures for the competitive environment concerning, among other things, access charge reform, universal service, number portability, mutual compensation and network unbundling/interconnection.

Cable systems face very different competitive circumstances. A recent Commission report demonstrates that cable incumbents are increasingly subject to competition. <u>The Second Annual Video Competition Report</u>[20] found that, as of September 1995, more than 5.7 million consumers obtained multichannel video programming from non-cable sources. This means that approximately 8.5 percent of multichannel subscribers obtain service from alternative providers, and the number appears to be growing in both absolute and percentage terms. Of course, these data represent only a portion of the universe of consumers that have a choice among multichannel providers.

The level of competition faced by cable companies contrasts dramatically with the competition experienced by local telephone companies. There are virtually no residential consumers with facilities-based telephone choices. This may explain why the Commission does

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19 Rather, "Pricing flexibility should be considered as part of the comprehensive package of actions to effectuate competition. Providing flexibility now would reduce the LECs' incentives to accommodate competition at just the moment when hoped for competition may be on the horizon. Comments of the National Cable Television Association, Inc., CC Docket No. 94-1, Dec. 11, 1995, at 10 ("NCTA Comments").

20 Annual Assessment of the Status of Competition in the Market for Delivery of Video Programming, FCC 95-491, rel. Dec. 11, 1995 ("<u>Video Competition Report</u>").

not issue an annual report on the state of local telephone service competition along the lines of the Video Competition Report. In essence, there is nothing to report. It also may explain why the telephone companies commenting in this proceeding tellingly offer no competitive data in support of their contention that regulations should be eased.

A. The LECs' Case for Additional Pricing Flexibility and Other Forms of Deregulation is Entirely Unpersuasive

The telephone parties rest most of their arguments upon the Commission's erroneously issued invitation to propose increased pricing flexibility irrespective of the level of competition, and on approaches to reconfigure the "pricing flexibility/ streamlining/ nondominant" classifications. Ameritech, for example, assumes that increased pricing flexibility regardless of the level of competition is a done deal, and does not even attempt to justify reduced oversight of "new services," alternative pricing plans and individual case basis tariffs.[21] Similarly, GTE presumes LECs will be granted additional pricing flexibility, without making any attempt to support the proposed changes.[22]

But despite the presumptuousness of these and other telephone parties, their proposals are relatively benign when placed alongside the submissions of other companies that advocate the dismantling of the regulatory process at the first "whiff" of competition. Bell Atlantic, for example, declares the whole existing process "outdated, anticompetitive and ultimately anti-consumer. It must be fundamentally overhauled."[23] Bell Atlantic advocates the elimination of the dominant/non-dominant classification and advance notice requirements. The company further calls for the removal of services from price cap regulation just as soon as competitive alternatives are available. Apparently, all of this could occur even if Bell Atlantic maintained complete control of every market in which it operates.

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[21] See Ameritech Comments in Response to Second Further Notice of Proposed Rulemaking, Dec. 11, 1995, at 4-23.

[22] See, generally, Comments of GTE, Dec. 11, 1995, at 3-37.

[23] Comments of Bell Atlantic, CC Docket No. 94-1, Dec. 11, 1995, at ii.

Pacific Bell ("Pacific") calls for subjecting regulations to tests of "simplicity," "efficiency," and "consistency." On grounds of simplicity, Pacific criticizes overlapping systems of regulation that might subject a carrier to price cap, streamlined, and nondominant treatment, at the same time, in the same geographic area, with respect to some of the same customers. Instead of requiring carriers seeking reduced regulation to demonstrate an individual service is competitive in a particular market, Pacific would have the Commission identify "competitive areas" based on "objective" criteria. Where an area is found "competitive," carriers "could offer access services under nondiscriminatory, generally available contracts, subject to Commission oversight but not price regulation."[24]

This broader brush arrangement, if adopted, would eliminate regulatory supervision of all access services at once, rather than on the basis of a service-by-service review. It would invite carriers to make claims that the availability of alternative access to business customers warrants the elimination of regulation of service to residential users. It is therefore unsurprising that on grounds of "efficiency" Pacific urges the Commission to abandon what it characterizes as "artificial" distinctions between switched and special access, calling the separate classifications "increasingly legalistic."[25] Pacific also criticizes the treatment of separate baskets as relevant markets on the ground that the baskets segregate services by service elements rather than by actual services.[26] While Pacific's last point may be well taken, it does not follow that all regulatory distinctions among services should be eliminated.

Having made its case that existing regulatory distinctions are no longer viable, Pacific goes on to argue on grounds of "consistency" that it should enjoy pricing flexibility in "high cost" areas to compensate for reductions in competitive areas. Of course, pricing flexibility of this sort is really nothing other than the cross-subsidization of competitive services with

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[24] Comments of Pacific Bell and Nevada Bell, CC Docket No. 94-1, Dec. 11, 1995, at ii ("Pacific").

[25] Id.

[26] Id. at ii-iii.

revenues from monopoly services. Pacific advocates contract-based pricing to accomplish its pricing goals.

Pacific is correct that the existing regulatory arrangements rest upon the maintenance of distinctions among services. The Second Further Notice accepts these distinctions as a constant, and then proposes to differentiate among services based upon the level of competition for the particular services and other factors. By claiming that the existing distinctions are no longer viable, Pacific presumes to vitiate the regulatory scheme, and leave almost nothing in its place.

BellSouth similarly jumps the competition gun. But rather than make the case that competition is present and that it has a significant impact on pricing decisions by market participants, the company instead relies primarily upon the removal of legal barriers, plans by some new players to offer service, and the first stirrings of actual competition in niche markets. Instead of recognizing that streamlined treatment should await actual competition, BellSouth argues that streamlined treatment should be granted upon a showing that (1) a competitive access provider ("CAP") or competitive local exchange carrier ("CLEC") has been certified in a particular geographic area; (2) a CAP or CLEC has become operational; and (3) the competitor's facilities have been deployed.[27]

Under BellSouth's proposal, this showing would trigger removal of streamlined services from price cap and Part 69 regulation, authorization of contract carriage pricing, granting to LECs of permission to file tariffs on 14 days notice with no cost support, and treatment of LEC tariffs for services qualifying for streamlined treatment as presumptively lawful. Nondominant classification would be based upon supply, demand and competitive conditions rather than market share. Carrier services held to be nondominant would be deregulated to the maximum extent permitted by law. As with the Bell Atlantic proposal, this could all happen even if BellSouth retained a market share of virtually 100 percent. Surely, that does not qualify as a competitive situation.

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[27] Comments of BellSouth Telecommunications, Inc., CC Docket No. 94-1, Dec. 11, 1995, at 5.

B. The LECs' Actual and Potential Competitors, and Those That Rely Upon Their Essential Facilities, Demonstrate Compellingly That No Additional Pricing Flexibility is Warranted

The LECs' competitors, and those that rely upon their essential facilities, share the view of NCTA that regulatory relief should be premised on the presence of actual competition, and should be dependent upon empirical demonstrations that competition is present. As the Ad Hoc Telecommunications Users Group ("Ad Hoc") observes, the experiencing of niche competition by some LECs in selected geographic markets cannot change the fact that LECs possess market power. Moreover, nothing in the comments shows that the LECs' market dominance does not remain near absolute.[28]

Time Warner Communications Holdings ("TWCH") contends that relaxing existing safeguards and granting pricing flexibility is improper until LECs face actual competition. Providing LECs with flexibility now "sends a chilling signal to potential investors in emerging facilities-based competitors."[29] Rather than devoting resources to the consideration of additional LEC pricing flexibility, the Commission should focus on the facilitation and promotion of competition by taking such actions as the expeditious completion of the virtual expand interconnection tariff proceeding and the telephone number portability proceeding.

Comcast urges the Commission to redirect its focus to promote local telephone competition through a three-part model. Phase I would involve a data collection process to determine the extent to which LECs face competition, and to establish mechanisms for tracking increased competition as it develops. In Phase II, the Commission would establish procedures to promote competition. Pro-competitive regulatory steps should include the promotion of "good faith negotiation of mutually compensatory interconnection arrangements with just, reasonable and nondiscriminatory rates, terms and conditions for access to LEC network facilities,

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[28] Comments of Ad Hoc Telecommunications Users Group, CC Docket No. 94-1, Dec. 11, 1995, at iii.

[29] Comments of Time Warner Communications Holdings, Inc., CC Docket No. 94-1, at 5.

databases, signaling systems and information." In addition, the residual interconnection charge should be eliminated because it serves to "artificially support LEC competitive ventures at the expense of LEC rivals and new entrants,"[30] and other steps to deter "regulatory gamesmanship to delay direct competition"[31] should be undertaken. Phase III would apply the competitive paradigm established in Phase II to promote competitive conditions by, inter alia, targeting the core elements of the LEC network and infrastructure to facilitate competition. The alternative focus on providing additional flexibility to the LECs will have the undesirable consequence of defeating, rather than promoting, competition.

On similar grounds, the California Cable Television Association ("CCTA") opposes the proposed regulatory changes prior to the development of competition.[32] According to CCTA, the cumulative effect on consumers and competitors of adopting the proposed changes could be "devastating," because the LECs retain market power and under the proposals they would obtain considerable regulatory relief irrespective of whether they comply with "competitive checklist" requirements. It is, therefore, critical that the Commission tie regulatory flexibility to compliance with specific checklist requirements.

AT&T notes that the LECs' bottleneck monopolies are "entrenched," and that "there are systemic impediments to full and fair competition in the interstate access and local exchange markets."[33] Moreover, there is no practical likelihood that the extent of the LECs' market dominance will decline meaningfully for many years. The Commission should, therefore, focus its energies on establishing the market preconditions to make competition possible. Only when there is substantial and measurable competition should regulatory oversight be reduced. AT&T further points out that the existence of competitive preconditions does not guarantee that actual

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30 Comments of Comcast Corporation, CC Docket No. 94-1, Dec. 11, 1995, at ii.

31 Id.

32 Comments of California Cable Television Association, CC Docket No. 94-1, Dec. 11, 1995, at 6-12.

33 Comments of AT&T Corp., CC Docket No. 94-1, Dec. 11, 1995, at i.

competition either exists or will exist in any market, and that it is fundamentally wrong to presume that a checklist of preconditions is sufficient proof of actual competition. It is also wrong for the Commission to adopt these new regulations so soon after its review of its LEC price cap regulatory system.

Sprint Telecommunications Venture ("STV") explains that even though competition for switched access is beginning, competitors continue to rely upon LEC facilities to obtain access to their customers. STV points out that LECs already systematically manipulate rates and other terms "to harm competitors and to preserve their market dominance."[34] The LECs "are no less likely to abuse any new pricing flexibility the Commission may grant them by strategically pricing their own access services wherever they face competition. The resulting cost-price squeeze will have a devastating effect on companies who are trying to bring customer choice to the market for the first time."[35] Moreover, the LECs already have sufficient pricing flexibility. Previously approved zone density pricing and volume and term discounts are sufficient in light of the level of competition that the LECs' face. Any additional pricing flexibility is unsupported by the record. STV concludes that "[d]ownward pricing flexibility, combined with the LECs' control over the timing and cost of interconnection with the local network, will permit LECs to engage, if not in classic predatory pricing, then in an equally effective price squeeze strategy."[36]

Teleport Communications Group ("TCG") makes a similar point. TCG maintains that there is no evidence that competition in the local exchange and switched access markets has advanced to the point where dilution of the FCC's current policies is appropriate.[37] TCG urges the Commission to establish appropriate linkages between checklist items, levels of actual competition and appropriate regulatory relief. TCG points to its one-half of one percent market

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[34] Comments of Sprint Telecommunications Venture on Second Further Notice of Proposed Rulemaking, CC Docket No. 94-1, Dec. 11, 1995, at 7 (citation omitted).

[35] Id. at i.

[36] Id. at 7 (citation omitted).

[37] Comments of Teleport Communications Group, Inc., CC Docket No. 94-1, Dec. 11, 1995, at 2.

share in New York ten years after commencing service there to demonstrate the general lack of actual competition.[38]

TCG further explains that the market opportunity created by the Commission's expanded interconnection policies is actually "very small."[39]

> For example, TCG was selected several years ago by Sprint to provide all of the transport for Sprint's switched access services in the New York LATA. Even after those circuits were transferred to TCG, NYNEX continued to receive 97% of Sprint's payments for switched access, and only 3% is retained by TCG. Such dependency of the new competitor on the ILEC will certainly constrain the new competitor's pricing, while simultaneously shielding the ILEC from competition on the vast majority of its revenues.[40]

On the basis of this experience and its more general finding regarding the present impediments to effective competition, Teleport concludes that the vast majority of the LECs' revenues are shielded from competition, and that "there is no need for the Commission to 'reform' price caps to 'meet competition.' There is as yet no competition for the [Incumbent] LECs to be introduced to, much less protected from, and hence no need for the Commission to rush to modify its price cap rules."[41]

In summary, the comments submitted in response to the Second Further Notice achieve a factual consensus. The LECs' actual and potential competitors, and those that rely upon their facilities, find that there are no significant facilities-based alternatives to the LECs. The LECs provide no evidence to the contrary. Indeed, one explanation for the near universal resistance of LECs to providing the market share data sought by the Common Carrier Bureau's recent data collection notice,[42] and instead advocacy of the more limited showing of the mere availability of

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[38] Id. at 2-3.

[39] Id. at 4.

[40] Id.

[41] Id.

[42] Public Notice, DA 95-2287, "The Common Carrier Bureau Seeks Comment on Telecommunications Provider Access Survey", rel. Nov. 3, 1995.

alternative sources of supply, is that a standard of "supply elasticity" might be satisfied even if the LECs' market share remained at nearly 100 percent.

The LECs creative theories aside, there is no basis for streamlining or nondominant status because there is no real competition. When competition arrives, and it has a significant impact on the prices LECs charge, the Commission can consider the streamlining and nondominant status options. The key question for immediate consideration is whether pricing flexibility is proper even in the absence of competition. For the reasons set forth above, the answer is "No" because the LECs already have sufficient pricing flexibility to respond to competition. Any further relief would grant LECs an unwarranted competitive advantage against nascent competitors and delay the day when consumers will have genuine service options.

III. LECS SHOULD NOT OBTAIN REGULATORY RELIEF SO LONG AS THEY ARE DELIBERATELY ATTEMPTING TO BLOCK COMPETITION

Proposals for relieving LECs of existing regulatory requirements are particularly misdirected because the elements of the competitive checklist have been neither agreed to nor implemented, and meanwhile there is compelling evidence that LECs are responding anticompetitively in the few situations where they face competition. NCTA's comments described several reported incidents in which LECs had agreed to interconnect their essential facilities in principle, but were refusing to offer reasonable interconnection in practice.[43] We noted that this approach appears to be part of a deliberate strategy by which LECs hope to persuade legislators and regulators that they are facilitating competitive entry, while at the same time deterring competition until they are permitted to enter the long distance business.

The LECs' behavior is not surprising. They control bottleneck monopolies, and as profit-maximizing businesses they want to hold on to their monopolies for as long as possible. It is very likely that until legislation is passed and effectively implemented by the Commission and

[43] NCTA Comments at 12-18.

the states, and effective competition is achieved, the LECs will continue to employ a variety of tactics that are designed collectively to impede competition.

In the development of its regulatory policies, the Commission must take into account the probability that LECs will use anticompetitive strategies to deter the development of competition. The Commission must adopt new procedures that effectively prevent anticompetitive practices, because existing arrangements are not sufficient. After all, the existing tariff and complaint procedures, and the local telephone monopolies, continue to coexist. Telephone companies might rightly perceive the Commission's refusal to adopt new procedures as an invitation to continue business as usual.

CONCLUSION

For the foregoing reasons, the Commission should adopt regulations and procedures consistent with the comments set forth herein.

Respectfully submitted,

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February 7, 1996

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of	)	
	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
	)	
Treatment of Operator Services Under Price Cap Regulation	)	CC Docket No. 93-124
	)	
Revisions to Price Cap Rules for AT&T	)	CC Docket No. 93-197

REPLY DECLARATION OF LELAND L. JOHNSON, Ph.D.

I, Leland L. Johnson, declare the following:

I am a consultant in telecommunications economics residing in Woodland Hills, California. I previously submitted a Declaration in support of the Comments of the National Cable Television Association filed December 11, 1995. My resume, attached to my initial Declaration, describes my professional experience and other qualifications.

Of key importance in these reply comments is that price caps cannot break the link between prices and costs, nor can they ever be expected to do so. Regulators cannot singlemindedly maintain fixed price controls regardless of LEC-reported changes in costs, possibly even driving the LEC into bankruptcy, simply to forestall cross-subsidization and predatory pricing. With the failure of price caps as an adequate safeguard against anticompetitive cost-shifting, the Commission -- and state regulators -- must maintain close scrutiny over the LEC's assignment of costs between its more competitive and less competitive services.

Comments filed by several economists on behalf of local exchange carriers contain several key assertions:

- Predatory pricing is not a threat in telecommunications because marginal costs associated with network operation are very low compared with the fixed cost of network construction. Accordingly, the incumbent would face extreme difficulty in driving the competitor out of the market through predatory pricing, because the marginal cost for the competitor to remain in the market is so low.
- Moreover, price caps prevent the monopolist from raising prices to fund the subsidies required for predatory pricing of competitive services.
- With anticompetitive cross-subsidies being no threat, the competitive services offered by monopoly carriers should be fully deregulated.

All of these points are wrong. On the contrary:

- Marginal costs are not low relative to fixed costs in telecommunications; because the costs are quite substantial to a competitor remaining in the market, the threat of predatory pricing is real.
- Price caps are not an effective safeguard against cross-subsidization and predation. They can best be regarded as similar to rate of return regulation with a time lag in adjustments between prices and costs.
- Because of the continuing threat of anticompetitive cross-subsidization, wise public policy dictates that the LEC's competitive, as well as non-competitive, services remain subject to regulatory scrutiny.